NFRD: embracing the challenge

Boards must understand the importance of sustainability and long-term value to their businesses, and that means taking non-financial reporting requirements more seriously.

Non-financial reporting requirements are nothing new for Europe's listed companies, yet regulators and investors feel that many still don't get it. The EU Non-Financial Reporting Directive (NFRD) is the latest attempt to persuade companies to integrate sustainability, amongst other areas, into key business structures and processes, and report what they are doing to tackle these key risks.

The ethos behind the NFRD is the same as the UK's Strategic Report (introduced in 2013), says Richard Karmel, head of sustainability at Mazars UK.

"Reporting is only 5% of the objective; 95% of the objective is to improve company performance and behaviours in these areas," he says.

"Many UK companies are still missing the point. They are approaching this reporting from a compliance and checklist viewpoint. The regulators are saying that companies need to become more fair and balanced in their reporting. However, to achieve this, companies need a better understanding of how their businesses are performing in these areas, which in many cases, is currently not the case."

National regulators around the EU will be watching to see if the latest rules and guidance are effective at pushing companies to do more, and report more, on non-financial matters. If progress is not made then companies may face tougher sanctions in future.

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A cycle of improvement

The emphasis on due diligence in the NFRD is one example of the greater focus given to what companies are doing. They are expected to go beyond a description of their policies on environmental or social matters and explain how due diligence processes have been implemented.

"In this context, due diligence means an ongoing process of understanding your current impacts and potential risks, building in processes to mitigate against and monitor those risks, and tracking them and feeding that information back into a cycle of continual improvement," says Karmel.

This means that companies should be looking for current issues that may be unseen as well as impacts that are foreseeable.

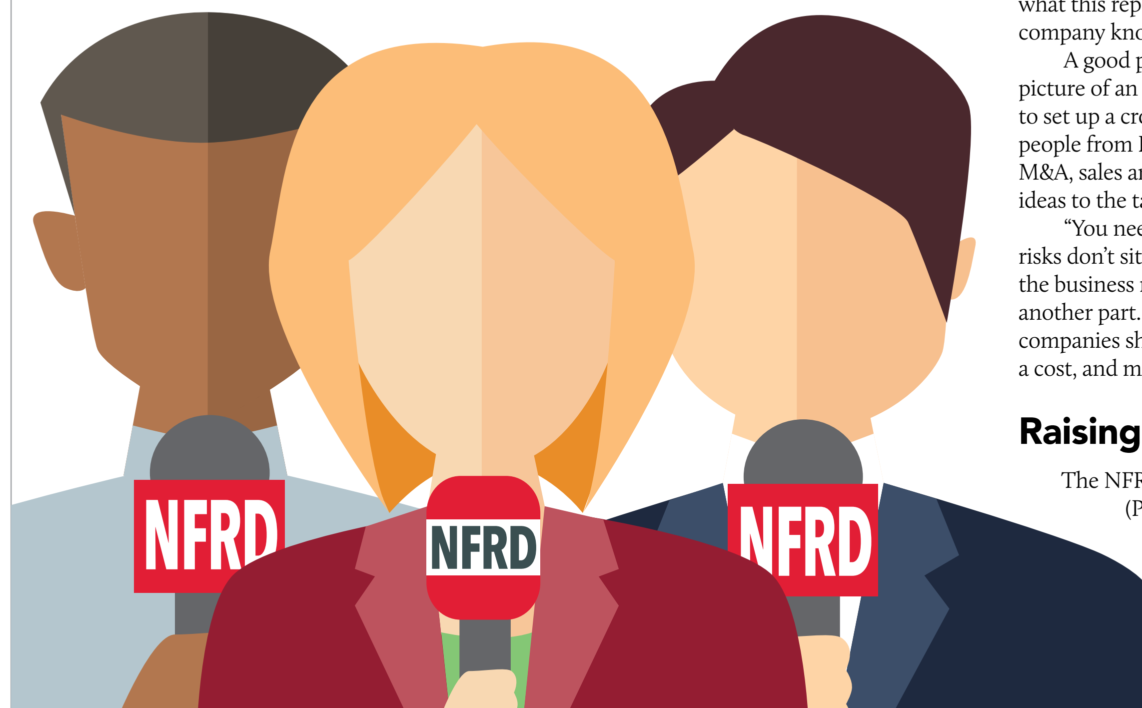
"The NFRD brings greater understanding and awareness of how businesses can really cause negative impacts in areas such as human rights, the environment and anti-bribery and corruption—even where to date they have been fortunate enough to avoid any major incidents," Karmel explains.

However, addressing these issues should not be seen as a compliance cost, but as an investment. It is an opportunity to protect the reputation of a company's brand through not only preventing harm to people and the environment, but also creating value for the business.

Karmel cites the example of a European garment manufacturer, which has operations and suppliers throughout Southeast Asia. The company has applied the UN Guiding Principles Reporting Framework (www.UNGPreporting.org), which requires greater engagement with suppliers to understand their resource limitations, the impact this has on human rights among their workforce and communities, and to help them to find solutions.

"On a recent visit, since applying the Reporting Framework, we were told that there has been an improvement in the quality of garments (that's a key performance indicator) and the number of product returns has decreased. Guess what? That led to higher profits," says Karmel.

The explicit demands for reporting on supply chain impacts and risks in the NFRD may be a significant challenge for companies, though.



This was only an implicit requirement of the Strategic Report. Guidance from the Financial Reporting Council in 2014 stated that companies should report on non-financial matters "when its influence, or potential influence, on the development, performance, position or future prospects of the entity's business is material to shareholders".

There can be a lot of working capital wrapped up in supply chains but the real reputational risks often go undetected. "If companies focus on their big suppliers then they are probably missing their largest reputational risk area, which is the small suppliers that often don't have the resources to deal with sustainability issues," says Karmel. "This is an area that companies are only just beginning to understand as social media disclosures of negative impacts are helping them realign their focus."

Good governance

From January 2017 companies that fall under the scope of the NFRD have been required to collect data on key sustainability risks. Importantly, there is likely to be greater scrutiny of the quality of data collected.

"The key thing is to make sure you're measuring the right things—the key drivers of real performance—not just the things that are easy to measure," says Anthony Carey, a partner at Mazars, who leads the board effectiveness practice in the UK.

There are a few existing sustainability standards which, for example, recommend a company report on the number of people within the organisation who have been trained in, say, human rights. However, what this reporting fails to capture is how that company knows the effectiveness of that training.

A good place to start to ensure a complete picture of an organisation's key sustainability risks is to set up a cross-functional oversight committee with people from HR, communications, legal, operations, M&A, sales and site managers, so they all bring new ideas to the table, says Karmel.

"You need a holistic approach because these risks don't sit with any one department. One part of the business may not be aware of risks that reside in another part. It requires a little upfront resource, but companies should regard this as an investment, not as a cost, and monitor the related return on investment."

Raising the bar

The NFRD applies to all public interest entities (PIEs) which have an average of 500 employees; it brings into scope a wider pool of UK financial services companies, including unlisted banks and insurers, than those covered by the Strategic Report.

In France, companies have had to extend their non-financial reporting since the introduction of the so-called "duty of vigilance" law, which was adopted by the French parliament on 21 February, and the French Bribery Act adopted in December 2016. The top 150 companies in France have to prepare a "plan de vigilance", which is an awareness report covering human rights, social and environmental matters, anti-bribery and corruption, and health and safety.

Companies are required to publish this report every year, or face an unlimited fine. A fine of €10m was originally proposed but appears to have been removed after last-minute business lobbying.

Germany has brought in similar guidelines, which means that companies are expected to produce a report covering similar non-financial reporting areas to the French one. While the German guidelines are voluntary, there's a sting in the tail: the German government has warned companies that if they don't report properly by 2020 it will turn these guidelines into mandatory law.

FUND MANAGERS ARE PAYING MORE ATTENTION TO NON-FINANCIAL REPORTING AS AN INDICATOR OF A COMPANY'S CORPORATE BEHAVIOUR AND ITS LONGER-TERM PROFITABILITY

Investor pressure

Fund managers are paying more attention to non-financial reporting as an indicator of a company's corporate behaviour and its longer-term profitability.

BlackRock CEO Larry Fink wrote in his 2016 letter to the CEOs of leading companies in the US and Europe: "Environmental, social, and governance (ESG) factors relevant to a company's business can provide essential insights into management effectiveness and thus a company's long-term prospects."

And BlackRock is not alone in this understanding. More surveys are now indicating that a significant majority of fund managers would reconsider their investments if they thought that their investment was linked to human rights impacts.

Anthony Carey says: "By comparing how companies report on sustainability risks, investors are looking to get an indication of how responsibly companies are managed and how seriously executives and non-executives take their obligations. For example, what is the board doing to ensure that the actual culture is aligned with the desired culture?"

The NFRD should be another step towards a fairer, more balanced and complete view of how businesses are doing, and should help provide a greater understanding of companies' future prospects.

The gap between companies that get it and those that don't will not only become clearer to investors and regulators, but also to all readers of accounts. ●

Partnership
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